

# Client Tax Letter

Tax Saving and Planning Strategies from your Trusted Business Advisor<sup>SM</sup>

## Planning for Today's Pensions



Some observers have commented that few private sector workers can look forward to pensions after retirement. The traditional pension, a lifelong stream of income to a retiree and perhaps a surviving spouse, is becoming a rarity for those who are not long-term government employees.

Nevertheless, millions of people *do* have a form of pension these days, one that kicks in after age 70½. At that age, required minimum distributions (RMDs) typically begin from retirement plans, such as traditional IRAs and 401(k)s. With proper planning, RMDs can serve as a long-term pension and also provide benefits to a surviving spouse.

### How RMDs work

Beyond age 70½, you generally must withdraw at least a certain amount from your retirement plan each year. The number is based on your age and the account balance at the end of the previous year. Any shortfall triggers a 50% penalty.

**Example 1:** Craig Jackson will reach age 70 this July, so he'll be 70½ in January 2018. His first RMD will be for 2018, based on his December 31, 2017, IRA balance.

Assume Craig's IRA balance will be \$600,000 then. He can go to the IRS "Uniform Lifetime Table" and find age 71: the age he'll turn in 2018. The IRS table shows a "distribution period" of 26.5 years at 71, so Craig will divide his \$600,000 IRA balance by 26.5, to get \$22,642, his RMD for the year. (IRA owners whose spouse is their sole beneficiary and is more than 10 years younger use a different table, resulting in a smaller RMD.)

Craig can withdraw a larger amount in 2018, but a smaller distribution will be penalized. If his 2018 IRA distributions total \$10,000, he'll lag the RMD by \$12,642 and owe a 50% penalty: \$6,321.

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## Senior Ceiling

*In 2017, the maximum Social Security benefit for a worker retiring at full retirement age (now 66) is \$2,687 a month, or \$32,244 a year.*

Each year, Craig will repeat the process, using the relevant distribution period and IRA balance. In the year he turns 76, for instance, the distribution period will be 22 years, reflecting a reduced life expectancy. If Craig has a \$440,000 IRA balance on the previous December 31, his RMD would be \$440,000/22, or \$20,000 that year.

### Pension planning

By following the RMD guidelines, Craig can construct a do-it-himself pension. He can contact his IRA custodian early in 2018, determine his RMD for the year, and request the annual amount to be paid in monthly installments.

**Example 2:** In our previous example, Craig's 2018 RMD will be \$22,642. That's \$1,887 per month, for 12 months. Craig can have the IRA custodian transfer that amount into his checking account each month, which effectively would provide him a pension for the year. The monthly RMD payouts would vary in future years, as explained.

RMDs from traditional IRAs generally are fully or mostly taxable, so Craig can choose to have taxes withheld, reducing the monthly deposit. Alternatively, Craig can receive the full RMD each month and make quarterly estimated tax payments.

Using the IRS table in this manner, year after year, Craig will never deplete his IRA, so he'll always have monthly cash flow. If he reaches age 90, for example, the distribution period on the uniform table will be 11.4 years, meaning that Craig's RMD will be about 8.8% of his IRA. The balance can stay in the IRA, growing tax-deferred.

If Craig's wife, Dana, survives him, and Dana is the sole IRA beneficiary, she can roll Craig's IRA into her own name. Then Dana can have her own RMD schedule—her own lifelong pension—in addition to RMDs from any IRAs Dana already has established herself.

Note that Dana and Craig can take more than the RMD obligation each

year. As long as they are older than 59½, there will be no early withdrawal penalties. However, taking more than the RMD likely will increase the tax bill and reduce the amount of future cash flow from IRAs.

### Easier riding

If you don't need money from your IRA in retirement, following the RMD table is the best way to minimize unwanted taxes. But what if you are relying on those funds for a comfortable lifestyle after you stop working? Then the IRS table can deliver a practical guideline for tapping your retirement fund.

By following the table, you will withdraw more from your IRA after a period of successful investing, and less after a market pullback has devalued the account. You won't have to worry about how much or how little to take out, with every hiccup of the financial markets. RMD-based IRA withdrawals, along with Social Security checks, can provide a lifetime stream of cash flow. ■

## Campus Tax Credits Can Top Tax Deductions

Besides financial aid, specific tax benefits can reduce the net cost of sending a child to college. Among the three major tax breaks—American Opportunity Tax Credit, Lifetime Learning Credit, tuition and fees deduction—you can claim only one on your tax return.

### American Opportunity Tax Credit (AOTC)

This credit, which has been extended through 2017, typically will be the best choice for parents of collegians. The AOTC can produce the biggest tax saving: as much as \$2,500 per student per year. In addition, the AOTC has the most generous income limits.

The maximum tax credit is available with modified adjusted gross income (MAGI) up to \$80,000 for single

filers, partial credits with MAGI up to \$90,000. For married couples filing joint tax returns, the comparable income limits are \$160,000 and \$180,000. Typically, MAGI for this credit is the same as your AGI, reported on the bottom of page 1 of your return.

To get the full \$2,500 in tax savings, your spending must be at least \$4,000 of qualified expenses for each college student. Qualified expenses include tuition and required fees but not room and board, transportation, insurance, or medical expenses. Unlike other education tax breaks, the costs of course-related books, supplies, and equipment that are not necessarily paid to the school can be qualified expenses.

You can take the AOTC for each of the first four years of a student's

higher education but not for subsequent years. Each year that you claim the

### Did You Know?

**F**our of the 10 most costly U.S. catastrophes on insured property occurred in 2004 and 2005. They include Hurricane Katrina, which cost \$41.1 billion, (then the costliest of all events on record) as well as hurricanes Charley, Ivan, and Wilma. As of last report, through 2014, the most severe event since then—number 10 on the list—was the 2011 Tuscaloosa, Alabama tornado, which cost \$7.3 billion.

Source: National Association of Insurance Commissioners

AOTC, you must claim the student as a dependent on your tax return. (You also can claim the AOTC for yourself and your spouse, if the other conditions are met.)

The AOTC is also refundable: If the AOTC reduces the tax you owe to zero before the full credit is used, 40% of the remaining credit amount (up to \$1,000) can be paid to you in cash.

### Lifetime Learning Credit

For the Lifetime Learning Credit, the income limits are lower than for the AOTC: for single filers, the MAGI phaseout range is \$56,000-\$66,000; for joint filers, the range is \$112,000-\$132,000 of MAGI. In addition, the tax savings can't be more than \$2,000 *per return*, not per student. The Lifetime Learning Credit is set at 20% of the first \$10,000 you spend on higher education. Otherwise, the rules for the Lifetime Learning Credit are similar to those for the AOTC.

If the AOTC is far more appealing, why use the Lifetime Learning Credit? Because the Lifetime Learning Credit might work when the rules for the AOTC can't be met. As mentioned, the AOTC only covers a student's

first four years of higher education. Students for whom the credit is claimed must be enrolled in college at least half-time for one academic period during the tax year. The Lifetime Learning Credit, on the other hand, is available for all years of higher education as well as for courses taken to acquire or improve job skills. You can claim the Lifetime Learning Credit for an unlimited number of years, so it can be useful once you've claimed the AOTC for four years.

### Tuition and fees deduction

A tax credit is generally better than a tax deduction, so either the AOTC or the Lifetime Learning Credit usually will save more tax than the tuition and fees deduction. You can deduct up to \$4,000 of tuition and required college costs with MAGI up to \$65,000 (single) or \$130,000 (joint). With larger MAGI, up to \$80,000 or \$160,000, you can deduct up to \$2,000 of those expenses. With even greater MAGI, no deduction is allowed.

Taxpayers with qualifying MAGI usually will be in the 15% or 25% federal tax bracket, so the tax savings may be modest.

**Example:** Ken and Kathy Long are in the 25% tax bracket. Taking a \$4,000 tuition and fees deduction reduces their tax bill by \$1,000: 25% times \$4,000. Thus, their tax saving is less than the \$2,000 possible from the Lifetime Learning Credit or the \$2,500 per student from the AOTC.

If that's the case, why would anyone choose this deduction, instead of one of the tax credits? Note that the income limits for the Lifetime Learning Credit are lower than the limits for the deduction. Thus, if the Longs can't qualify for the AOTC (say, they've already used it for their child for four years) or for the Lifetime Learning Credit (their income is just over the Lifetime Learning Credit threshold), they may be able to benefit from the tuition and fees deduction.

Also, this deduction is taken as an adjustment to income, reducing your AGI. (A tax credit reduces your tax obligation, not your AGI.) A lower AGI, in turn, may offer benefits throughout your tax return. Our office can make sure you use the most effective education benefit on your tax return. ■

## The Second Best Investment You Can Make

Many companies offer 401(k) or similar retirement plans to their employees, and an employer match might be available. If that's the case, you should contribute to the plan at least enough to get the full match.

**Example 1:** Melissa North earns \$80,000 a year. Her company's 401(k) plan offers a full match for up to 6% of salary. Therefore, Melissa should contribute at least \$4,800 (6% of \$80,000) to her 401(k) account this year, which will entitle her to a \$4,800 company match.

Whether you're offered a full or partial match, you should contribute at least enough to get all the dollars your company offers. Failing to get the maximum match means you're giving up free money: relinquishing part of your compensation package.

### Paying down debt

Getting your employer match is a no-risk way to earn a 100% return (or a lesser return, with a partial match) on your money. If that's often someone's best investment move, paying down debt

may be next best. When you reduce a loan balance and thus reduce the interest you're paying, you're effectively earning the loan interest rate.

**Example 2:** Owen Palmer has a credit card that charges 12% on unpaid balances. When Owen prepays \$1,000 of his balance, he saves \$120 (12% of \$1,000) in interest that year. That's a 12% return on his outlay. What's more, credit card interest typically is not tax deductible. Thus, Owen earns 12%, after tax, by prepaying his loan.

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It's possible that Owen could receive a higher return by doing something else with his \$1,000, but that probably would mean taking substantial risk. Prepaying debt, conversely, has no investment risk beyond forgoing the chance for a higher return. In today's low-yield environment, prepaying debt can be appealing.

### Evaluating education loans

Prepaying credit card debt may be attractive for many people, but prepaying student loans can be a tougher call. Interest rates may be lower than on credit card debt, so the benefit of prepaying is not as great. What's more, up to \$2,500 of interest on student loan debt is tax deductible each year. To get the maximum deduction, your modified adjusted gross income (MAGI) can be no more than \$65,000,

or \$130,000 on a joint return. Partial deductions are allowed with MAGI up to \$80,000 or \$160,000.

If interest is tax deductible, the benefit of prepaying the loan is reduced.

**Example 3:** Rita Simmons has outstanding student loans with a 7% interest rate. This year, she expects to fall in the 25% federal tax bracket, so paying the interest actually saves her 1.75% (25% of 7%) in tax. Thus, Rita's net interest rate cost for her student loans is 5.25%: the 7% she pays minus the 1.75% she saves in tax.

In her situation, Rita would earn 5.25%, after tax, by prepaying her student loans. That could be a good move, for an outlay without investment risk, but it's also possible that Rita could earn more by investing elsewhere. Moreover, Rita would have to relinquish liquid assets by prepaying, and replacing

those assets in case of an emergency might not be simple.

### Money from home

Prepaying a home mortgage may be even less beneficial than prepaying student loans. Assuming a 4% interest rate and a 25% tax rate, the after tax benefit of prepaying would be only 3%. Although virtually all homeowners can deduct mortgage interest, the net payoff is even smaller for taxpayers with tax rates higher than 25%.

The bottom line is that prepaying a loan makes the most financial sense with high interest rates and low tax benefits. State income tax also should be considered. Our office can help you calculate the true return of debt prepayments, so you can make informed decisions. ■

## Using IRA Money to Buy a Business Can Be Dangerous



Business owners may need capital to support growth, and the money in their IRA can be tempting. Nevertheless, the pitfalls can be steep, as illustrated in a recent Tax Court case (*Thiessen v. Commissioner*, 146 T.C. No. 7 [3/29/16]). Here, the court ruled that because a married couple had entered into prohibited transactions

with respect to their IRAs, the assets in the IRAs were deemed to have been distributed, resulting in a huge tax bill.

### Describing the transaction

When James Thiessen left a long-held job after declining to relocate, he found a metal fabricating business

(call it ABC Co.) for sale. Through a friend who had executed such a transaction and also from a broker, James heard about the use of IRA money to help finance the purchase.

Therefore, James and his wife, Judith, hired tax and legal advisers. Proceeding according to plan, the Thiessens created a new C corporation

(call it DEF Co.); James and Judith were DEF's officers and directors. They both also established IRA accounts. Then they rolled a total amount of more than \$430,000 from their employer-sponsored retirement accounts into the IRAs.

As the next step, the Thiessens' IRAs purchased all the shares of DEF, the new company they had created; then DEF used the money from the IRAs to buy the assets of ABC. In addition to the IRA money, DEF transferred a \$200,000 promissory note to ABC's seller in the purchase. ABC's assets secured the note, which James and Judith personally guaranteed.

### The seven year hitch

This all happened in 2003. In 2010, the IRS asserted that the Thiessens' guarantee of the note was a prohibited transaction, which resulted in a deemed distribution of

all of the assets in their IRAs. The couple was taxed on the deemed distribution of the over \$430,000 they had rolled over into the IRAs, plus a 10% early withdrawal penalty, because James and Judith were both younger than 59½. Ongoing tax deferral on the funds distributed was lost, and the Thiessens owed over \$180,000 in income tax, according to the IRS. The Tax Court ruled in favor of the IRS, upholding the agency's claim.

Usually, there's a three-year statute of limitation on the time in which the IRS can assess extra income tax. However, there's a *six-year* window for the IRS in

cases where the taxpayer substantially understates income. That was the case here because the Thiessens had not included the deemed distributions from their IRAs in income on their 2003 return. The IRS' 2010 filing came within six years of the date in 2004 when the Thiessens filed their 2003 tax return.

### Debt was the downfall

The Tax Court agreed with the IRS that the Thiessen's plan failed because they had personally guaranteed the promissory note that DEF transferred in the purchase of ABC's assets. The Tax Court found that

the Thiessens' "guaranties of the loan were prohibited transactions and [the Thiessens'] IRAs ceased to qualify as IRAs on account of the guaranties." As a result, all the funds in the IRAs were deemed distributed in a taxable transaction in the year the Thiessens guaranteed the promissory note.

This transaction proved to be very costly for the Thiessens. Other pitfalls can arise when IRA money is used to acquire a small business. If you desire to have your IRA own a business, our office may be able to help you put together an arrangement in keeping with the rules against prohibited transactions. ■

## Automatic Enrollment Retirement Plans

Some states have passed laws requiring employers, including many small businesses, to offer retirement plans to employees. Other states may follow in the coming years, with some form of a mandate. Often, these rules have an automatic enrollment feature.

Automatic enrollment plans may offer advantages to business owners, even if they're not required. Federal law, in effect for the last decade, provides a roadmap to show you how to get those benefits and avoid problems.

### In, unless they're out

As the name implies, automatic enrollment plans put eligible workers into a company-sponsored retirement plan. These plans usually are 401(k)s, but they can be any type of plan that requires an employee contribution from earned income. Employers put a specified percentage of each covered worker's earnings into the plan, although each employee can contribute more or less, if desired. Conversely, employees can opt out of the plan and, thus, avoid a reduction in current cash flow.

Among the acceptable arrangements, many companies choose a "qualified" automatic enrollment plan. These plans require at least a 3% employee contribution, gradually increasing each year, along with either:

- a matching contribution of 100% of an employee's contribution up to 1% of compensation, and a 50% matching contribution for the employee's contributions above 1% of compensation and up to 6% of compensation; or
- a nonelective contribution of 3% of compensation to all employees eligible to participate in the plan, including those who choose not to contribute any amount to the plan.

Commonly, employers choose to make the 3% nonelective contribution.

**Example:** XYZ Corp. enrolls employees Arlene Walker and Tim Miller in its 401(k) plan. Both have salaries of \$40,000 a year. Arlene contributes 3% of her pay (\$1,200), but Tim opts out and contributes nothing to the 401(k). Even so, XYZ contributes \$1,200 to a 401(k) account for Tim

as well as \$1,200 to Arlene's 401(k) account this year.

Thus, offering an automatic enrollment plan can be expensive, considering administration costs and employer contributions. Why should business owners consider them?

For one reason, offering a qualified automatic enrollment plan can meet safe harbor provisions that exempt the plan from annual nondiscrimination testing requirements. Without this safe harbor,

### Did You Know?

**T**he U.S. economy is the world's largest, with gross domestic product (GDP) over \$18.5 trillion in 2016. China ranks second, with \$11.4 trillion in GDP, followed by Japan (\$4.4 trillion), Germany (\$3.5 trillion), the U.K. (\$2.8 trillion), France (\$2.5 trillion), and India (\$2.3 trillion). Italy, Brazil, and Canada round out the top 10.

Source: [statisticstimes.com](http://statisticstimes.com)

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low plan participation among middle- and lower-income workers might limit allowable tax-deferred contributions from key employees of the sponsoring company, including the business owner or owners.

Offering any retirement plan, moreover, can deliver intangible benefits. Having a plan may help a company hire and retain desirable workers. Employee morale and productivity might improve. Furthermore, many business owners

will find satisfaction in providing their workers with increased retirement security.

### Another safe harbor

With automatic enrollment arrangements, questions regarding investment selection may arise. Some employees may stay in the plan, yet not say how they want their money invested. If you put them into a bank account or money market fund, returns

will be negligible; put them into stocks or bonds and any investment losses might trigger lawsuits from unhappy plan participants.

To address this concern, the federal government has designated certain investments as qualified default investment alternatives (QDIAs). If a retirement plan participant does not choose an investment, and the sponsor puts that employee's money into a QDIA, the sponsor may be relieved of responsibility for poor investment results.

By far, the most popular QDIAs are life cycle funds, known as *target date funds*. Balanced mutual funds (those holding equities and fixed-income securities) and professionally managed accounts also may be QDIAs. Stable value funds can be QDIAs, too, for certain short-time periods. All of these QDIAs may be used for any employer-sponsored retirement accounts when the participant does not select an investment, not just for automatic enrollment plans.

As might be expected, the rules on automatic enrollment plans can be complex. If you are interested in such a plan for your company, our office can help you comply with all the requirements. ■